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ACQUISITION
TECHNOLOGY
AND LOGISTICS

OCT 19 2005

Mr. Barry Holman
Director, Defense Capabilities and Management
U. S. Government Accountability Office
Washington, D.C. 20548

Dear Mr. Holman:

This is the Department of Defense (DoD) response to the GAO Final Report, 'DEFENSE INFRASTRUCTURE: Management Issues Requiring Attention in Utility Privatizations', (GAO Code 350557), dated May 12, 2005 (GAO-05-433). I appreciate your revisions of the draft report. In light of my further review of the Final Report, the Department will be issuing new guidance to address the key issues. I have enclosed a detailed response for each recommendation and discussed our plan of action.

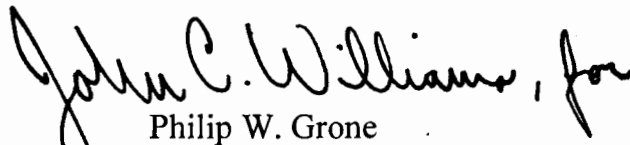
I strongly urge you to reconsider your suggestion that the Congress consider a suspension of further utility privatization efforts. Our plan of action will adequately address each of the issues raised during your review. You have brought some significant issues to light and we will ensure that they are addressed. The DoD Components are already providing the suggested independent reviews prior to future utility conveyances. With existing guidance these reviews will prevent any recurrences of the valid issues raised by your report. The updated guidance being developed with the DoD Components will provide further reassurance that every conveyance will reduce the long-term costs of the Department compared to the costs of continued ownership.

As you know, the House of Representatives has proposed legislation to suspend the utilities privatization program for at least a year. If enacted, this suspension will likely lead to the cancellation of many solicitations. With about one third of the 1500 evaluations pending decisions on open solicitations, much of the government's investment to develop solicitations will be wasted. About twenty more systems require the issuance of a competitive solicitation for all Department of Defense utility systems to have been considered under the program. Your review did not identify any fundamental defects in the solicitations. Taking steps resulting in the cancellation of these solicitations and wasting this enormous effort by the Department and industry is not warranted. The costs to restart the program will be significant.



The House of Representatives has also recommended eliminating all funding for utilities privatization in the Navy and Air Force, including funding for contracts awarded in previous years and the management and oversight of the ongoing program, based in part on your report. Eliminating the funding for oversight is a contradiction of your report's recommendation to provide increased attention to these areas. The elimination of oversight will adversely impact mission support and place considerable risk on the effective management of existing utility services contracts that have resulted from a utility conveyance.

Over 100 military utility systems have been conveyed resulting in a total cost avoidance of over \$730 million. This represents nearly \$4 billion of utility infrastructure, which is now meeting the safety and reliability standards of the utility industry. As we complete the evaluations of the remaining 475 utility systems already under solicitation, I look forward to working with you to ensure the Department can take advantage of the investments made to complete these evaluations and achieve the efficiencies possible through the Utilities Privatization Program.


Philip W. Grone
Deputy Under Secretary of Defense
(Installations and Environment)

Enclosure:
As stated

GAO REPORT – DATED May 12, 2005
GAO CODE 350557/GAO-05-433
“DEFENSE INFRASTRUCTURE:
Management Issues Requiring Attention In
Utility Privatization”

DEPARTMENT OF DEFENSE COMMENTS

GAO RECOMMENDATION 1: *“As long as savings are expected to be a key factor in utility privatization decision making, revise the guidance for preparing economic analyses so that the analyses compare the cost of a proposed privatization contract with the cost of continued government ownership on the basis of the actual planned expenditures and the timing of these expenditures.”*

DOD RESPONSE 1: Partially concur with the concept of the revised recommendation. It is the Department’s intent to fund the requirement for reliable utility services that are essential to support our forces and their quality of life. The Department is developing the modeling tools needed to more accurately predict the long term program requirement. As these tools allow the Department to more closely align planned expenditures with the requirement, this recommendation will be realized. However, until the tools are mature the government estimate of what it “should cost” to provide utility services at the appropriate standard is the most accurate measure of the projected long-term requirement for a particular system to be retained by the government. The Department intends to improve the reliability of utility systems retained by the government, which will require an increase in the average funding per system even with the efficiencies accomplished by efforts such as the utilities privatization program.

GAO’s recommendation is based on an installation level perspective of future funding availability compared to the requirement to provide utility services at an appropriate standard. Following years of under-funding, many military utility systems are not fully capable of supporting mission requirements or a quality workplace for Department personnel. Without the tools to support a significant paradigm shift, these installations will have a low expectation for increased funding to provide reliable utility support. Therefore, to comply with the GAO recommendation today would require some installations to develop a solicitation for utility services at standards well below those expected by customers of the utility industry. This recommendation would undermine the Department’s policy of taking advantage of industry innovations, economies of scale, efficiencies, private sector financing, better business practices and expertise to improve utilities services. The utility industry is unlikely to embrace the concept suggested by the GAO recommendation. Barring a major delay the DoD Components have invested the necessary resources to complete over 95 percent of the 1500 utility privatization evaluations by the end of Fiscal Year 2006. Incorporating this recommendation as intended by GAO would waste the significant investment made to develop the 475 solicitations under evaluation.

DoD guidance issued in October 2002 directed Defense Components to develop an estimate of what it “should cost” the government to provide utilities services at the appropriate standards.

This “should cost” estimate is compared to proposals from industry participants. The should cost estimate is the government’s best tool for predicting the requirement for individual systems. Considering the Department’s need and intent to provide utility services at the appropriate standards, the October 2002 guidance properly addresses the economic test required by 10 USC § 2688, which requires an analysis of the long-term costs to the United States.

(1) *the long-term economic benefit of the conveyance to the United States exceeds the long-term economic cost of the conveyance to the United States.* The evaluation of long-term economic benefit against long-term economic cost measures what it should cost the Government to operate the utility system if it was maintained at industry standards vs. what industry would operate the system under their operating standards.

(2) *and, the conveyance will reduce the long-term costs of the United States for utility services provided by the utility system concerned.* This evaluation compares the life cycle cost reduction at industry standards.

To meet the program objectives and to analyze the long-term costs and benefits, comparing the government’s estimate of “should cost” to the offerors’ proposal is the most reliable method of determining which ownership option is most advantageous to the government. The Department maintains that 10 USC § 2688 does not require that the economic analysis be completed on the basis of the actual planned expenditures and the planned timing of those expenditures for a particular utility system in the context described by GAO.

Plan of Action:

1. Considering the intent to provide reliable utility services support, continue to use the appropriate industry standard in determining the long-term costs to the United States for utility services provided by the utility system concerned.
2. Continue to develop tools for better predicting the requirements for providing adequate utilities services.

GAO RECOMMENDATION 2: *“Require an independent review, perhaps by DOD headquarters or the services’ audit agencies, of the economic analyses supporting proposed privatization projects.”*

DOD RESPONSE 2: Concur with this revised recommendation. In light of the long term nature of these deals and the concerns raised by Congress, the appropriate guidance will be updated to require that the Defense Components conduct an independent review of utility conveyance decisions to address the issues raised by GAO.

Plan of Action:

1. Update guidance to require an independent review of the economic analysis supporting any proposed utility conveyance under 10 USC § 2688.

GAO RECOMMENDATION 3: *“Provide general program guidance emphasizing the need to consider increased utility costs under privatization as the military services prepare their operation and maintenance budget requests.”*

DOD RESPONSE 3: Concur with this revised recommendation. Updated guidance will remind DoD Components to consider the increased costs for utility services contracts resulting from a conveyance. The Defense Components already adjust installation operation and maintenance budgets based on anticipated program requirements, priorities and available fiscal resources. The increases and decreases within the appropriation will include the increased costs from utility services contracts resulting from a utility conveyance.

The DoD Components are already responsible for funding the utility services contracts resulting from a system conveyance. Utility service contracts are a must-pay bill. The GAO example of the funding of the Fort Irwin electrical distribution services contract provides an example of the need to prioritize requirements in a rational manner. The perceived lack of funding in the first quarter of FY2005 at Fort Irwin resulted from resources being diverted to support the Global War on Terrorism. Funding was in-fact available to address all must-pay obligations including the electrical distribution services contract awarded in 2003. Though delayed until an internal funding transfer could occur, the Army funded this must-pay contract bill.

Plan of Action:

1. Update guidance reminding the DoD Components to consider increased costs for utilities services contracts resulting from a conveyance.

GAO RECOMMENDATION 4: *“Place greater scrutiny on the implementation of the fair market value requirement in proposed contracts to minimize cases where contractors recover more than the amounts they paid for system conveyances.”*

DOD RESPONSE 4: Partially concur. In many cases, the contractor’s expenses related to the conveyance contribution will appropriately be greater than the Fair Market Value (FMV). Because the analysis of the allowable and reasonable costs related to a utility conveyance can be a complex process, it is essential for the contracting officer to fully understand the impacts of FMV on the contract price. Updated guidance will require Defense Components to appropriately address fair market value in proposed utilities services contracts resulting from a utility conveyance. As addressed in the February 25, 2005 report to Congress on the “Implementation of Common Commercial Business Practices in the Department of Defense Utilities Privatization Program”, when systems are conveyed, the new owner will make a capital investment, which will include the FMV for the utility system and capital improvements required to provide service at industry standards. The price of the long-term utility service contract will include the recovery of those costs of capital, unless the system has the ability to earn revenue from other customers. In conducting the utilities privatization evaluations, contracting officers will typically consider all the contractor’s costs for capital investments.

In most sectors of the utility industry, if additional facilities are required to serve a new customer, that customer must fund the cost of those added facilities. Therefore, the requirement

to receive a contribution for the conveyance of military utility systems creates a special business case, which may create transaction costs. To effectively consider the unique aspects of the utility industry, the Department has granted specific deviations to the Federal Acquisition Regulations (FAR) that may allow contractors to recover certain costs related to the purchase of utilities systems following a conveyance. Interest related to the purchase price and other capital investments required by the contract are allowable costs. Federal income taxes specifically related to a Contribution in Aid of Construction may also be allowable. With these FAR deviations, Contracting Officers are able to structure contracts in accordance with the terms and conditions generally followed by the utility industry. If the contractor has tied up capital assets due to the liability of the FMV contribution, the contract price may reflect a reasonable return on that investment. The Source Selection Authority must ensure that overall government costs are minimized. The evaluation of the FMV and the recovery of said amount must be reviewed within the context of the overall economic analysis. Regardless of the business case used in a proposal, the system will not be conveyed unless the long-term benefits exceed the long-term costs relative to continued ownership.

Plan of Action:

1. Update guidance to appropriately address fair market value in proposed utilities services contracts resulting from a utility conveyance.

GAO RECOMMENDATION 5: *“Issue program guidance, specific to utility privatization, emphasizing the importance of contract oversight.”*

DOD RESPONSE 5: Concur. In the near future the appropriate guidance will be updated to emphasize the importance of contract oversight.

Plan of Action:

1. Update guidance emphasizing the importance of contract oversight.

GAO RECOMMENDATION 6: *“Reassess whether permanent conveyance of utility systems should be DOD’s preferred approach to obtaining improved utility services.”*

DOD RESPONSE 6: Concur. The Department has reassessed this issue. Utility services contracts resulting from a utility conveyance may include a contract clause that provides an option for the government to purchase the system at the end of the contract period. This will provide the government with additional leverage in contract renewal negotiations.

Most proposals currently under evaluation are based on a permanent conveyance. Where conveyance with a full title transfer is uneconomical, the DoD Components have been encouraged to consider conveyance of a lesser estate if it will reduce long-term costs to the government. To complete the evaluation of 1500 utility systems, the Defense Components will need to issue competitive solicitations for less than twenty more utility systems.

Plan of Action:

1. Clarify need to control risk of cost growth on subsequent utilities services contracts.

GAO RECOMMENDATION 7: *“Ensure that installation operations and maintenance budgets are adjusted as necessary to reflect increased costs from utility privatization projects.”*

DOD RESPONSE 7: Concur. As stated in the DOD Response to Recommendation 3, the DoD Components are already responsible for funding the utility services contracts resulting from a system conveyance. The DoD Components make the required adjustments for these must-pay contract costs as part of their programming and budgeting responsibilities. DUSD (I&E) will update the appropriate guidance to remind DoD Components to consider increased utility costs under privatization.

Plan of Action:

1. Update guidance to remind DoD Components to consider increased utility costs under privatization.

GAO RECOMMENDATION 8: *“Issue specific utility privatization contract administration guidance including the clear assignment of responsibilities and ensure that resources are provided to perform adequate contract oversight.”*

DOD RESPONSE 8: Concur. As stated in the response to Recommendation 5, the Department will update guidance to the DoD Components to contract oversight. DUSD (I&E) will continue to monitor progress in this area and make future program adjustments as appropriate.

Plan of Action:

1. Update guidance emphasizing the importance of contract oversight.

GAO RECOMMENDATION 9: *“On the basis of DOD’s comments on our recommendations, as discussed below, the Congress may wish to consider requiring DOD to address the issues and recommendations discussed in this report before proceeding with further utility privatization efforts.”*

DOD RESPONSE 9: Strongly non-concur. Citing GAO Report 055-433 the House Armed Services Committee (HASC) recommended suspending the authority for conveying DoD utility systems until at least the enactment of the National Defense Authorization Act for Fiscal 2007. To reflect the reduction in the FY06 requirement for awarding new utilities services contracts resulting from a conveyance, the HASC also recommended a reduction of \$89.6 million to the utility services accounts of the Army, Navy and Air Force. The Department opposes the suspension of utilities conveyance authority because it would waste a significant investment in privatization evaluations of utility systems throughout the United States. The proposed suspension will prevent the Department from yielding the expected benefits from the \$250 million investment mentioned in the GAO Report 055-433.

Most of the preparatory costs have already been expended and the proposed suspension would waste a large portion of that expenditure. Open solicitations for 475 systems would be suspended for over a year, or, more likely, canceled by the industry, resulting in significant re-solicitation costs for both the Government and utility industry. These solicitations represent one

third of the systems determined available for a privatization analysis. This would also represent a significant loss to industry. Since 1997 the Department has endeavored to take advantage of industry innovations, economies of scale, and efficiencies to improve the reliability of utility services. Barring this proposed delay, the enormous effort to evaluate all military systems will be essentially completed in FY06. One result of a suspension will be the reassignment of DoD subject matter experts to other priorities and the current synergy gained by developing a center of expertise will be lost. Industry teams will also disband, creating start-up costs once the suspension is lifted.

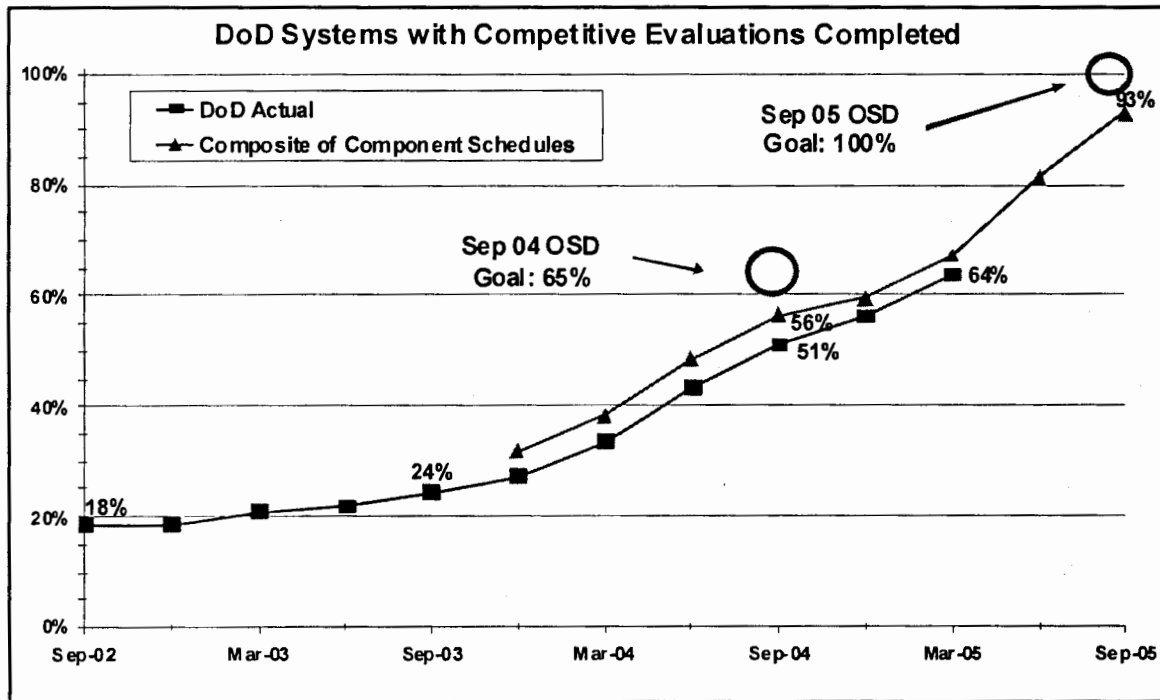
Further, the Department opposes the House reduction of utilities services funding because it eliminates the utilities privatization program within the Navy and Air Force, including costs of contracts awarded in previous years and management and oversight of the ongoing program during the suspension. By eliminating oversight and management of the programs, the proposed funding reduction would adversely impact mission support and place considerable risk on the effective management of existing utility services contracts that have resulted from a utilities conveyance. The May 2005 GAO report (GAO-05-433) identified oversight and management of the utilities privatization program as areas of particular concern and in need of increased attention. The HASC cited the GAO report as a basis for the suspension. Eliminating the funding for oversight is a contradiction of the GAO recommendation. Further, the GAO report did not identify any concerns for the Navy utility privatization efforts, which executed in a significantly different manner from the other services.

The proposed funding reduction also eliminates \$6.1 million central funding for the increased costs resulting from utility conveyances in previous years. The service contracts resulting from these conveyances have already been awarded and are a must pay bill.

The Utilities Privatization Program has improved the safety and reliability of utility services through the conveyance of nearly \$4 billion of utility infrastructure. Through September 30, 2005, the Department has privatized 143 systems with an estimated cost avoidance of \$730 million. Of the utility systems still pending evaluation, the Army expects to convey an additional 90 systems, which could generate an additional \$300 million in cost avoidance. Once the remaining evaluations are complete, the Department's total cost avoidance from utility conveyances is expected to exceed \$1 Billion. The following table provides a breakout of the conservatively estimated cost avoidance resulting from the program:

Military Department	Number of Utility Systems Conveyed	Estimate of Cost Avoidance (\$K)
Army	111	\$ 591,000
Army projection of future conveyances		\$ 300,000
Navy	16	\$ 93,000
Air Force	16	\$ 48,000
DOD Totals	143	\$1,032,000

The Department's program has shown steady progress in making competitive evaluations. The following graph depicts progress to date through March 31, 2005 and the remaining plan.



The Department has already emphasized the importance of following existing policy, which addresses the issues raised in the GAO report. DoD Components are now conducting independent reviews prior to conveyance. Additional guidance will be issued to aggressively address the issues outlined in the GAO report. Our oversight will ensure that the numerous ongoing evaluations are completed in an effective manner that benefits the Department.

DOD ACTION 9:

1. Update guidance to address GAO recommendations.
2. Monitor progress.
3. Dialog with GAO and the Congress to make further improvements to the DoD utilities privatization program.